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AIRLINE REGULATION BY THE CIVIL AERONAUTICS BOARD

INTRODUCTION

The Senate Subcommittee on Administrative Practice and Procedure recently completed an eighteen month oversight investigation of the Civil Aeronautics Board. During this investigation, the Subcommittee conducted two sets of hearings lasting ten days and filling almost three thousand pages of written record. In addition, the Subcommittee reviewed the answers to extensive questionnaires submitted by the airlines and the CAB and studied a long list of economic reports, including several prepared especially for the Subcommittee, as well as many briefs, court opinions, and CAB opinions and staff studies. Last June a draft of the Subcommittee's report was circulated to all witnesses and other interested parties and the final report was carefully revised in light of their comments and corrections.

The summary of the Subcommittee's final report follows. More detailed analysis and documentation may be found in the full report and the hearing record, which may be purchased from the Government Printing Office in Washington, D.C. I fully subscribe to the views expressed in this report and hope they may prove helpful to others.

*Senator Edward M. Kennedy
(D. Mass.)*

Summary of Report of the Senate Subcommittee on Administrative Practice and Procedure*

This report presents the recommendations, conclusions, and analyses of the members of the Subcommittee on Administrative

* The Summary is reprinted here in the exact form in which it was received from the Subcommittee.

Practice and Procedure arising from the subcommittee's comprehensive 1975 investigation of the Civil Aeronautics Board's practices and procedures. In that inquiry the subcommittee asked two basic questions: First, whether the Board's practices and procedures are fair. Are the Board's decisions made openly after adequate opportunity for affected persons with differing views to present evidence and arguments? Are they based upon evidence in the public record? Second, whether the Board's practices and procedures are effective. To what extent have they led to "adequate, economical and efficient service by air carriers at reasonable charges?" Have they both encouraged the growth of a healthy aviation industry capable of satisfying the Nation's need for air service and made that service available to the traveling public "at the lowest cost consistent with the furnishing of such service?"

The subcommittee has reached five general conclusions concerning the CAB's practices and procedures during the past few years:

1. The Board's practices, while effective in promoting industry growth, technological improvement, and reasonable industry profits, have not been effective in maintaining low prices. It is economically and technologically possible to provide present air service at significantly lower prices, bringing air travel within the reach of the average American citizen.

2. Several of the procedures that the Board follows in setting major Board policies—in particular, route and enforcement policies—have lacked the openness, intelligibility, and impartiality required by elementary notions of procedural fairness.

3. The CAB should shift the focus of its attention from the problem of promoting the growth of the aviation industry—a goal that is consistent with a large number of aircraft, frequently scheduled service, and comparatively empty airplanes—to the problem of making that service economically available to more of the American public—a goal that is consistent with fuller planes, reasonably frequent service, and significantly lower fares. The Board's present ratemaking procedures are ill suited to this goal. Instead, it will be necessary for the Board to encourage price competition, to adopt a more liberal entry policy, and to use more sparingly its power to grant immunity from the antitrust laws.

4. To secure the adoption of these policies, Congress should

enact legislation designed to limit the CAB's powers to control prices, restrict entry, and confer antitrust immunity.

5. The shift towards a policy that relies heavily upon competition must take place gradually, allowing reasonable transition period for the industry to adjust.

The following few pages will summarize the report's argument supporting these general conclusions and the more specific recommendations it contains. The facts and figures contained in this report are based upon the state of the industry, the economy, and regulation as the subcommittee found them in the spring of 1975, and, unless otherwise noted, do not reflect those changes in regulation that may have taken place since, or in response to, criticisms voiced at the hearings.

I. BACKGROUND

A combination of Federal subsidy and Federal regulation is largely responsible for the present structure and performance of the domestic scheduled airline industry. Before 1934 the Post Office administered a system of subsidy that carried with it substantial power to determine which airlines would fly which routes. Dissatisfaction with this system led Congress between 1934 and 1938 to try alternatives, including the vesting of significant regulatory power in the Interstate Commerce Commission. 1938 saw the creation of what is essentially the present system of airline regulation by the Civil Aeronautics Board, with the twin objectives of promoting the growth of aviation while maintaining fares sufficiently low to allow the public access to air travel.

The Board is equipped with three basic powers: 1) The entry power: the power to grant or to deny "certificates of public convenience and necessity" which an airline must have to fly interstate; 2) the rate power: the authority to suspend or to set air fares; 3) the antitrust power: the power to approve (or disapprove) agreements among airlines, with approval conferring immunity from the antitrust laws. In addition, the Board has certain subsidiary powers, including the power to authorize mergers, the power to administer a subsidy, the power to regulate certain peripheral matters of airline service (baggage liability, tariff quotations, discrimination), and the power to enforce its own regulations.

The domestic industry has grown phenomenally since 1938: revenue passenger miles have increased from 476 million to 114 billion; investment has grown from \$30 million to \$7 billion. Scheduled carriers now serve 430 cities. Still, the basic structure of the industry has changed surprisingly little.

In 1938 the industry consisted of sixteen trunk carriers; today those sixteen have been reduced through merger to ten, which account for more than 90 percent of all scheduled airline service. In addition, local service carriers provide scheduled regional service; supplemental carriers provide charter service; and small unregulated commuter carriers provide local service. Finally, several scheduled carriers provide service wholly within California and Texas, which is not regulated by the CAB since it does not cross state lines.

II. THE BASIC ARGUMENT: SHOULD THERE BE MORE COMPETITION?

A. THE THEORY

The Board's critics claim that its reliance upon classical route-award and ratemaking procedures has brought about fares that are far too high. The airline industry is potentially highly competitive, but the Board's system of regulation discourages the airlines from competing in price and virtually forecloses new firms from entering the industry. The result is high fares and security for existing firms. But the result does not include high profits; instead the airlines—prevented from competing in price—simply channel their competitive energies toward costlier service: more flights, more planes, more frills. Thus, the skies are filled with gourmet meals and Polynesian pubs; scheduled service is frequent. Yet planes fly across the continent 50 percent empty. And fares are "sky high."

The remedy is for the Board to allow both new and existing firms greater freedom to lower fares and greater freedom to obtain new routes. This freedom should lead the airlines to offer service in fuller planes at substantially lower prices, a form of service that most consumers desire.

Although a more competitive system with lower fares on fuller planes can be profitable, the process of introducing new firms or price competition may create added financial risk for some existing

airlines in the short run. Yet short-term financial security for all individual carriers is currently being purchased at a fearsome price in excess fares—an excess used to support the purchase of more planes than are needed. This excess has been estimated at between \$1 to 3.5 billion annually. It should be possible to introduce increased competition gradually, thereby bringing air travel into the lives of millions of working people who now cannot afford it, without seriously jeopardizing the health of the industry.

B. EMPIRICAL EVIDENCE

The strongest empirical confirmation of the critics' argument arises from comparing fares and service in California and Texas—where new firms and price competition have been allowed—with flights elsewhere in the Nation where competition is more restricted by the CAB. A traveler flying 456 miles from San Francisco to San Diego pays \$26. On strictly comparable routes elsewhere in the country the traveler must pay at least 60 percent more as of February 1, 1976, \$47 to fly 399 miles between Boston and Washington, D.C. A comparison of virtually any intrastate route (which the CAB does not regulate) with virtually any comparable interstate route (which the CAB does regulate) reveals similar fare differences.

Several major airlines argued that it was not CAB regulation but certain special circumstances that brought about such low fares within California and Texas. These included better weather, denser traffic, less congestion, the absence of interlining costs, the ability to operate turnaround service, and less need to support other routes in the system. The subcommittee examined each of these other factors in detail and concluded that taken together, these factors account for only less than half of the fare differences. The rest arises from the fact that the intrastate carriers carry more passengers in their planes. The subcommittee also concluded that greater freedom to compete is probably responsible for these fuller planes and lower fares. New airlines willing and able to provide the public with fuller-plane, lower-fare service in California and Texas have been allowed to enter those markets, and the low-fare service they provide has led to greatly increased demands for air travel with a resulting increase in scheduled flights.

The California experience also suggests that a more competitive

environment does increase business risks for individual carriers. But this added risk for individual firms does not seem to have seriously inconvenienced the public, for throughout this period continuity of low-fare service was maintained.

Further empirical evidence is contained in cost data submitted by Lockheed and Boeing, which show that it is economically and technically possible to provide California-type fuller-plane, lower-fare service throughout the United States. With an all-coach seating configuration, for example, cross-country service could be provided in a B-747 at fares that range from \$75 to \$95. The current (as of February 1, 1976) cross-country CAB-regulated fare is \$174.

Similarly, "value of time" studies suggest that all except the highest paid executives would prefer lower fares even if they were accompanied by a significant reduction in the number of flights flown, which they would probably not be. Finally, studies of air service in Canada, commuter service, and Military Air Transport Service suggest that where competition has flourished, fares tend to be low; where there is strict price regulation, they are high.

C. COUNTER ARGUMENTS

The major arguments against allowing freer entry and greater price competition rest upon the fear of: 1) predatory pricing; 2) destructive competition; 3) monopolization; 4) reduced service to small communities; 5) destruction of the existing air service network; 6) reduced safety standards; and 7) greater financing difficulties. The subcommittee examined each of these claims.

In the subcommittee's view there is no substantial historical, empirical, or logical reason for believing that increased reliance upon competition would lead to predatory pricing, destructive competition, or risk of monopolization.

The small community and "network" argument have two separate forms. First, it is often claimed that fares on popular routes must be high to cover the cost of less popular service. Investigation of this claim suggests, however, that no significant amount of such "cross subsidy" takes place. The subcommittee has carefully examined empirical studies submitted by United Air Lines and the Air Transport Association. It concludes that a more competitive system, of the type recommended by this report, might lead the

major trunk carriers to seek to discontinue service over routes that, at the very most, account for one-half of 1 percent of revenue passenger-miles now flown. Service over these routes even then would not terminate but, in all probability, would be supplied by commuter carriers. Even if contrary to the subcommittee's expectations, direct subsidy were needed, it could be supplied at a cost of several million dollars per year—a small price to pay for annual savings that could amount to more than a billion dollars.

Second, it is argued that increased competition will lead to fares that prevent the airlines from covering their overhead, forcing them to replace fewer planes and eventually to shrink their systems. Investigation of this claim suggests that though fares should fall as a result of fuller plane service and subsequent cost reduction, they will not fail to cover costs, for both new competitors and old ones will realize (as in all competitive industries) that failure to cover overhead means eventual bankruptcy. Of course, increased competition may lead to changes in the individual route maps of one or more existing carriers. But, it should not significantly alter the extent to which towns are served by the system taken as a whole. In fact, lower fares to and from major hubs should increase demand for air travel to and from smaller communities as well, with the probable result that service to those communities will increase, not diminish. In any event, the subcommittee projects that the gradual introduction of increased price competition and more liberalized entry will not diminish service to smaller towns, nor will it injure the nationwide service network.

The subcommittee is convinced that increased competition would not affect carrier safety. Safety is the primary responsibility not of the CAB, but of the Federal Aviation Administration. The FAA would continue to apply its rigid safety standards. The safety records of both the scheduled carriers, subject to full fledged CAB rate and entry regulation, and the supplemental carriers, subject to less-stringent rate and entry regulation, are excellent. As no change in safety regulation is proposed, those records should remain excellent.

The subcommittee does not believe that increased competition will raise any serious difficulty for the financing of new aircraft. It will, however, increase business risks for individual firms when

compared with a more sheltered environment protected by the CAB, which has never allowed a major airline to go bankrupt. The subcommittee has sought to minimize these risks by recommending a gradual transition to a more competitive environment. This transition should also allow adequate time for any unforeseen adverse consequences to appear and to be dealt with.

In sum, the subcommittee believes that a gradual transition to a significantly more competitive industry environment will bring substantial benefit to the American traveler without jeopardizing the financial health of the aviation industry.

III. PRESENT BOARD REGULATION

The subcommittee's recommendations for reform of airline regulation rest in large part upon its detailed examination of existing CAB practice. In each major area of CAB regulation, the subcommittee has found serious problems of unfairness and ineffectiveness. It has concluded that present CAB practice is fundamentally deficient.

A. ROUTE ENTRY POLICY

The Federal Aviation Act instructs the Board to issue a certificate of convenience and necessity allowing an airline to fly a particular route if "the applicant is fit, willing, and able . . . and such transportation is required by the public convenience and necessity." The statute requires the Board to set an application for public hearing and to "dispose of such application as speedily as possible." The legislative history of these provisions suggests that Congress intended the Board to implement a cautious, but moderately liberal, policy allowing new firms to enter the industry as the market for air travel expanded. The Act's sponsors, Senators Harry Truman and Pat McCarran assured the Senate that the 1938 Act would not prevent new entry into the industry.

The route policies actually followed by the Board, however, have been quite different. First, entry into the industry has been effectively blocked. Between 1950 and 1974 the Board received 79 applications from firms, outside the domestic scheduled airline industry, wishing to offer domestic scheduled airline service. Not one was granted. With a few minor exceptions, since 1960 the Board has not even set such applications for hearing. Moreover,

since 1969 the Board has imposed a "route moratorium," refusing to allow even firms inside the industry to acquire new routes, nor would it set such applications for hearing.

Second, the Board has awarded routes in a manner designed to keep the market shares of the major existing firms fairly stable. In 1938 the four major carriers—United, American, Eastern and TWA—accounted for 82.5 percent of all revenue passenger miles flown; in 1972, they accounted for about 60 percent. In 1938 United, the largest airline, accounted for 22.9 percent of the market; in 1972 after merging with Capital, it accounted for 22.0 percent. Moreover, the Board has not allowed any major carrier to go bankrupt, but, instead, has authorized mergers. The present ten domestic trunk carriers directly descend from the sixteen in business in 1938; the nine existing local service carriers descend from nineteen airlines allowed to provide local service directly after World War II. No new domestic trunkline has ever been authorized, and only one new local-service carrier has been authorized since 1950.

2. *Procedural Problems*

a. General problems.—The three most serious general defects in the procedural system used for the awarding of routes are: 1) *Delay*.—More than two-thirds of all major route applications on the CAB's docket at the beginning of 1975 had been pending for more than two years. More than one-quarter had been pending for more than five years—a particularly large number in light of the fact that applications pending for more than three years tend to be dismissed automatically as stale. While delay is a problem common to many government agencies, in the case of the CAB it has helped to maintain a highly restrictive route award policy.

2) *The "motion for an expedited hearing."*—The CAB enforces its substantive route policy primarily through its disposition of a procedural motion which any airline applying for a route must make. Simultaneous with or subsequent to filing for a route award, Board procedure provides for an applicant to file a motion requesting an expedited hearing on that route application. Ostensibly, this is simply a procedural motion. In reality, if the Board is willing to grant the route itself, it then grants a hearing. If it is unwilling to grant a route, it denies a hearing. Thus, the decision

that is supposed to be made *after* a hearing—whether or not a route is to be awarded—is really made *prior* to the hearing. In effect, the hearing is held only if the decision to award the route has already been made. Applications denied “expedited” hearings languish on the CAB’s docket for three years and are then dismissed as “stale.”

This system effectively insulates the CAB’s route decisions from criticism and review. Because a restrictive route policy takes the form of “refusals to grant expedited hearings,” reviewing courts are less likely to interfere, for the CAB claims that it is simply exercising its discretionary power to organize its own docket. The losing applicant has an uphill battle to convince a court to overturn a decision that on its face seemed to say only that it must wait for an “ordinary” rather than an “expedited” hearing. Of course, an “ordinary” hearing is seldom ever held.

3) *Lack of standards.*—Studies prepared for the subcommittee confirm the conclusion reached by many Board critics: namely that the Board lacks consistently applied standards in route cases. The decision to award new route authority has been governed by a host of standards, which aim at promoting efficient, integrated systems. Yet, these standards are not only varied and complex; they are inconsistently applied. More importantly, the decision as to which carrier is to be awarded a new route is, in the words of the Board’s own staff, “random.”

From 1969 through 1974 the Board implemented a “route moratorium,” a policy consisting of a general refusal to grant or even to hear applications for new routes. In 1969 and 1970 Board Chairman Secor Browne and several other Board members became concerned about overcapacity in the industry, a problem frequently mentioned to Board members by industry representatives in private meetings. Chairman Browne then gave a series of speeches calling for route restraint. He let the staff know that the Board’s policy was not to award new routes. As a result, the Board and the staff did not act on route applications; it simply did not provide hearings. In essence, the basic reason for the Board’s failure to set route cases for hearing in the past few years is not lack of administrative resources but, rather, a policy decision by the Chairman, taken without hearings or formal con-

sultation with other Board members, to slow down the granting of route awards.

In the subcommittee's view, this method of determining important route policy was highly improper and probably unlawful. For one thing the CAB held no public hearing about whether or not it ought to adopt a more restrictive route policy. Yet, such a hearing was plainly called for. The policy itself of refusing to grant hearings would seem to conflict with the Board's statutory obligation to set route applications for hearing and to dispose of them "as speedily as possible" for another. Finally, the failure to articulate a clear policy together with the Board's enforcement of that policy through the procedural device of refusing expedited hearings, made it virtually impossible to obtain judicial review of the "route moratorium" policy.

Instead of using this highly informal procedure to effect a major change of Board policy, the Board should have published notice of its intent in the Federal Register and held a public hearing. The public would then have had an opportunity to argue the merits of the route moratorium, the Board would have been exposed to a variety of other positions about the best way to cure industry problems, and the affected parties might then have appealed an adverse decision to the courts.

4) *Other improprieties.*—In examining the procedures used to develop and enforce the route moratorium, the subcommittee discovered a number of disturbing examples of Board practice. First, a memorandum sent by an administrative law judge to Board Chairman Robert Timm stated, "the following route cases, which have been set for hearing by Board order, have not been noticed for a conference and hearing before an administrative law judge pursuant to informal instructions of the Chairman's office in connection with the unofficial route moratorium." The evidence demonstrated that the "informal instructions" were sent by the office of the previous Chairman, Secor Browne, without consultation with other Board members. The type of informal action that this memorandum suggests is highly improper.

Second, the frequency of informal private communication between Board members and representatives of industry is troublesome particularly when—as in the case of the route moratorium—

the meetings are followed by Board speeches and actions that reflect the views of major airlines. Although there may have been no impropriety committed at any particular meeting, the subcommittee recommends that the Board reformulate its rules dealing with *ex parte* communications. Those rules should not forbid informal contact with the industry; such contact is often necessary and desirable. They should, however, require logging and disclosure of private communications so that, in cases where Board policy is at issue, the public will be able to monitor industry inputs and those with different views will have a greater opportunity to meet and to dispute industry arguments.

Third, throughout this period, all route memorandums prepared by the Board's Bureau of Operating rights contained three parts: a recommendation, a description of the effect on the industry's rate of return, and a discussion. While rate of return is one, among several, factors that the Board might take into account in a route case, highlighting it in this way suggests that it is the most important factor, which it ought not to be.

5) *A basic difficulty.*—The difficulty of developing consistent route award standards may have tempted the Board to develop and enforce route policy through procedural decisions—decisions which are more difficult for courts to reverse and the public criticize. That fact, in turn, may have made the Board less sensitive to the need for holding hearings prior to major changes in substantive policy. In any event, the procedural complexity and unfairness constitute independent reasons supporting development of clear route award standards. The Board might move in the direction of awarding routes to any “fit, willing, and able” applicant, or in an opposite, highly restrictive direction. The subcommittee believes that the least restrictive of these paths is the right one.

6) *Conclusion.*— In the subcommittee's view, the Board's route policies in general and its present route practices and procedures in particular have tended to thwart the provision of low-cost air transportation to the American public. Its restrictive entry policies have inhibited price competition that might otherwise have brought about lower fares and fuller planes; they have tended to stabilize the market shares of major firms. On the other hand, the Board has made serious and successful efforts to promote the expansion

of the nation's air transport system and to produce a reasonably efficient route network; it has also avoided carrier bankruptcy.

Nonetheless, the subcommittee believes that the overriding goal of airline regulation now ought to be neither the protection of existing carriers, nor continuous industry promotion; instead it should be securing low-fare air transportation for the vast majority of the American public.

Moreover, procedural considerations suggest the need for fairly simple, coherent route award standards—standards that avoid giving the Board discretion to hand out such valuable commodities as routes free from effective court review. Such standards can be found in a system that moves towards awarding routes to those “fit, willing and able” to fly them.

B: RATE POLICY

1. *Background.*—The problems of the CAB's rate policies arise from the fact that the Board has tried to apply classical principles of price regulation to an industry a) that is structurally competitive, b) that is composed of several firms, each of which has different route structures, costs, and revenues, and c) that faces continuously changing cost and demand conditions. There are three basic ways in which the Board might try to carry out this task: First, it might hold lengthy public hearings concerning fares, and each change in fares, of each separate firm; second, it might set fares through informal negotiation with the industry; third, it might devise complex system of formal rules designed to set fares almost automatically. The Board has dismissed the first of these methods as impractical; it practiced the second for some time, until the courts held it unlawful (it deprives all but the airlines involved of a meaningful opportunity to participate in the ratesetting process). More recently, the Board has tried the third approach—the development of a set of rules that should automatically determine what constitutes a “reasonable” fare, thus simplifying the hearing process.

The subcommittee concludes that the Board's present system of ratesetting (embodied in its recent *Domestic Passenger Fare Investigation* decisions), while administratively workable, tends to keep air fares unreasonably high. The subcommittee believes that the other two approaches—frequent individual hearings and informal

negotiation—are neither practical nor desirable. Thus, it recommends that the Board revise more substantially its approach to rate-making; it should no longer attempt to apply classical principles of ratemaking to this competitive industry operating in a volatile economic environment. Instead, the Board should rely more heavily upon competition—greater freedom to set rates together with greater freedom to enter the industry—in order to obtain low fares.

2. *The Present System.*—Although the Board has the power to set carrier rates directly, because of the elaborate hearings required the Board has rarely exercised that power. For the most part its control of carrier rates takes the form of approving or disapproving requests for changes in present rates filed by carriers. In reviewing such requests in recent years the Board has applied standards set down in its recently completed *Domestic Passenger Fare Investigation* (DPFI). Those standards are designed to produce almost automatically “just and reasonable” fares.

Classical ratemaking—which works best when applied to a single firm, such as an electric utility—first determines the firm’s “revenue requirement” by taking its costs and adding a reasonable return on investment. It then sets the firm’s prices so that they generate this “revenue requirement.” The Board applies these principles with important modifications: First, the Board looks, not at individual firms, but at industry, cost and revenue figures. Second, it adjusts the figures submitted to it in order to determine what industry costs and revenues *would have been* if the industry had met certain “load factor,” seating and other Board standards. The Board sets a “revenue requirement,” which equals the industry’s “adjusted” costs (the costs it would have had had it met the Board’s standards) plus a 12 percent return on investment. Third, the Board sets fares at a level sufficient to generate this “revenue requirement.” This fare level consists of a fixed charge (now about \$14) plus several cents per mile (more per mile for shorter flights). Fourth, the Board publishes every 3 months a compilation of industry cost and revenue figures with adjustments. Thus, it is a simple matter for any firm to determine exactly what fare level the industry is entitled to set. It can then file a new tariff embodying that fare level, and the Board should be reasonably certain to approve it.

a. The Effect on Price.—The subcommittee has determined that the present system, though it may be administratively desirable and an improvement over past practice, has failed to keep prices low and has probably contributed to the rapid increase in air fares (not commensurate with increases in costs).

Those features of this system that have tended to keep ordinary fares at unreasonably high levels include the following:

1) *The “load-factor” standard is too low.*—Studies based upon the value passengers place on their time, as well as experience in California, where passengers have chosen to fly in planes 60 to 70 percent full, show that most travelers—if given the choice—would prefer to fly in planes fuller than the Board’s 55 per cent and to pay correspondingly lower fares.

2) *The “load-factor” standard represents an industry average.*—The Board’s standards push the industry toward flying planes 55 percent full on average but allow load factors to vary widely on particular routes. Planes on more competitive long-haul, transcontinental routes have tended to fly emptier than those on less competitive short, or medium hauls. Most travelers probably would prefer the opposite pattern of frequency of service.

3) *By insisting that carriers charge equal fares for equal distances, the Board effectively prevents selective price cutting.*—In industries with only a few firms, fear of immediate retaliation makes general price-cutting rare; price floors are eroded only as firms each begin to make a few selective price cuts in limited areas. The CAB’s rule of “equal fares for equal distances” tends to make a carrier thinking of cutting prices on some routes cut prices on all of its routes and it thus discourages any price-cutting at all. The rule does not produce “cost-related” fares, for routes of equal distances often have very different costs. Instead, the rule, which is imposed for reasons of administrative convenience, leads to excess service on some routes, inadequate service on others, and varying degrees of route profitability, which in turn encourage the CAB to distort route structure in order to help low-profit carriers.

4) *The Board’s rules inhibit across-the-board price cuts.*—The Board’s rules would not allow a carrier to cut its prices across the board if, when the cut is met by its competitors, the entire group

of rivals will not earn a 12 percent return. Thus, the ordinary workings of price competition, through which more efficient firms can capture customers from less efficient, are stopped. And a carrier believing that travelers would prefer fuller-plane, lower-fare service is effectively prevented from testing out its beliefs in the market place (for they might lead to one or more rivals at least temporarily losing money).

5) *The Board's profitability standards and demand projections are highly inexact.*—After hearing conflicting opinions about the “proper” profit level and how demand is likely to respond to changes in price, the subcommittee believes that the present CAB profit standard (12 percent return on total investment; between 17 percent and 22 percent return on equity) is high. But, it also believes that there is no scientific rate setting system that can produce precise answers to these highly uncertain questions.

6) *Other features.*—Although firms can obtain almost automatic fare increases when the Board's rules show that fares are too low, the Board's statutes make it difficult to force a rate reduction when it believes fares are too high. Moreover, the system, which works on an industry average, does not easily allow the Board to determine whether a low industry return which might justify a fare increase is temporary or permanent, regional or national, caused by one carrier's problems or general.

b. *The Effect on Efficiency.*—By preventing selective price cutting and inhibiting general price cuts, the Board's policies tend to tolerate inefficiency, for it is difficult for more efficient firms to take business from the less efficient. Indeed, there are wide variations in firm efficiency. The Board has made little effort to penalize inefficient carriers. It may be hindered from doing so by its own rate (and subsequent route) policies which make it difficult to tell the extent to which high costs reflect inefficiency or a higher cost route structure.

c. *The Effect on Profits.*—The Board's policies may have had little effect in raising the general level of industry profits. The actual level of industry profits in most years has been well below the Board's target. Some expert witnesses believed that greater freedom to cut prices would increase industry profits by bringing about lower fares (and greater demand) during economic downswings.

4. *Conclusions.*—While some of the difficulties mentioned might be overcome through a reordering of the Board's priorities away from its traditional concern with maintaining industry's stability, there can be no major improvement without the abandonment of a purely administered rate procedure and the substitution of greater reliance upon the forces of competition in both route and rate areas. Thus, the subcommittee recommends freedom for the carriers to lower their fares and, as a more liberal entry policy takes effect, to raise them as well. As one immediate part of this effort, the subcommittee recommends the adoption of considerably more liberal charter rules and a subsequent expansion of charter service.

Alternative methods designed to bring about lower-fare, fuller-plane service are likely to be inadequate or undesirable:

a. A Board effort to raise load factor standards is desirable but inadequate.

b. The Board should encourage the provision of areas that embody discounts based upon cost differences; fares that discriminate in price are less satisfactory.

c. Efforts to bring about lower fares through CAB-approved scheduling restrictions have proved a failure. They have brought about inferior service without any reduction in price. Such efforts should be abandoned.

C. ANTITRUST IMMUNITY: CAPACITY RESTRICTING AGREEMENTS

Ordinarily, agreements and concerted action between firms are unlawful under the antitrust laws if they unreasonably restrain trade. Agreements among airlines concerning scheduling, service, equipment, and several other matters must have Board approval to take effect. That approval carries with it immunity from attack under the antitrust laws. The Board receives about 1,000 requests for such approval each year; and about 10 percent of those requests raise significant antitrust issues.

The subcommittee has investigated in detail two of the most important controversial areas in which the Board has wielded its extraordinary power to immunize otherwise unlawful business conduct from the antitrust laws: minimum charter rates (which is the subject of a separate subcommittee staff report) and capacity re-

stricting agreements. The subcommittee's conclusion about capacity restricting agreements are similar to those it reached in the case of agreements to establish minimum charter fares, namely, the Board has followed procedures that are improper, and has promoted a result that harms, far more than helps, the traveling public.

Experience with capacity restrictions is enlightening for restrictions constitute one possible response to the basic problem noted by the Board's critics: The fact that Board rules that inhibit price competition will simply lead the airlines to engage in service competition instead. The airlines realize that too much service and excessive scheduling also mean lower profits. And, like their critics, they realize that frequency and timing of service is one of the few competitive outlets under price and entry regulation. The dilemma, then, was how to reduce service and operating costs without losing passengers to a competitive airline on a particular route. The response was that, in 1970, when, due to overcapacity, airlines profits fell dramatically, a number of major carriers agreed collectively to cut the amount of service on major routes. The advantage (from the airlines' point of view) of collective rather than unilateral behavior was that service reductions on multi-airline routes could be tailored so that no airline was put at a competitive disadvantage, that is, so market shares could be preserved. Between 1971 and January 1975, the Board continually approved these agreements—usually for short periods of time initially, followed by renewed approval. In fact, agreements reducing capacity (*i.e.*, limiting service) in the four major transcontinental markets have been in effect since October 1971.

They have been in effect in 20 other markets since October 1973; and they were in effect in the New York-San Juan market off and on from June 1972 to March 1974. The Board viewed them first as emergency economic measures to raise carrier profits and later as fuel saving measures. It held no hearing on these measures until mid-1973, when it began a hearing that concluded in later 1974. An administrative law judge then concluded that the agreements were both harmful and unlawful.

1. *The Agreements' Effects.*—Limitations on capacity, it has been argued, can reduce carrier costs and thereby bring about low-

er fares. The subcommittee found, however, that capacity restricting agreements brought about significantly reduced service on major routes *without* any compensating fare reduction *nor* any slowdown in the rate of fare increases. More specifically:

a. In the agreement markets, planes are more crowded; load factors increased 10 percentage points or more.

b. Profits in the agreement markets increased substantially. Profits, for example, on Los Angeles-New York, New York-San Francisco, Los Angeles-Washington, and Chicago-San Francisco routes increased to between 17 and 24 percent.

c. Some cities were hurt due to travel decline. In the two months of February and March of 1974, for example, Las Vegas lost about \$1 million in nongambling revenues because of inability of travelers to secure plane reservations.

d. A great many passengers were unable to secure the flights they wished. For example, in just one 3-week period in October 1973, in four transcontinental markets United alone placed 1,465 people on its waiting list.

e. Employees have been laid off. The Air Line Pilots Association estimated that United and TWA have laid off more than 1,000 employees as a result of the capacity reductions.

f. The effect on price is negligible. There have been no price cuts resulting from these agreements. In fact, between the end of 1973 and 1974 prices increased nearly 20 percent on capacity restricted routes as well as others. On such routes the public paid the same, or more, for less service.

2. *The Agreements' Justifications.*—The subcommittee does not believe that the justifications offered for the capacity restricting agreements outweigh the harm they cause. Contrary to the claims of their proponents:

a. *The agreements are unlikely to eliminate waste or to lower fares.*—To bring about lower fares, the agreements would have to fill airplanes to the point where *industry*-wide profits exceeded 12 percent. It is extremely unlikely that they could do so for several reasons. First, the Board cannot limit service competition on most routes, for it cannot *force* carriers to enter into these agreements. Many smaller carriers, relying upon better service to attract customers from larger rivals, will not enter into them. Thus, on most

routes service competition continues. Second, the agreeing carriers may transfer airplanes from restricted routes where they are not needed to unrestricted routes. Such transfers, which are nearly impossible to detect, will shift the problem of excess capacity and losses to different groups of routes and airlines. The agreeing carriers may enjoy improved profits but average industry profits would stay about the same. Third, airplanes that are grounded because they are no longer needed may stay in the firm's rate base with their cost still charged to the consumer.

b. The agreements were not needed to raise industry profits.—For one thing, it is unlikely, for the reason just stated, that the agreements could raise *industry* profits, even though they might help some individual carriers. For another thing, industry profits were not so low as to require special emergency action. Excess ordering of equipment plus the cyclical nature of demand drove return on industry investment down to 1.5 per cent in 1970. Yet, this level was comparable to other cyclical lows, when no special action was taken. It seems more reasonable to ask airline shareholders to bear the burden of overly optimistic management investment decisions (through temporarily low profits) than to ask the consumer to do so (through agreements to reduce service). Further, the very fact that the Board promoted industry agreements not to compete lessened the incentive for individual carriers to cut back service unilaterally.

The agreements themselves have not saved any significant amount of fuel. Rather, fuel savings took place simply because the Federal Energy Office restricted the total amount of fuel that air carriers were allowed. It might be argued that agreements helped the airlines to maintain a better balanced pattern of service, yet Delta airlines, which did not enter into capacity restricting agreements, was able on its own to preserve an equally desirable balance of service between small and large towns.

3. Procedural Difficulties.—The major defect in the procedure followed by the Board consists of its failure to hold a full hearing prior to putting capacity restricting agreements into effect. The upshot of the Board's action is that passengers in restricted markets had to suffer inadequate service and high prices for four years on the basis of reasons that failed to convince an administrative law

judge once that hearing was held. Indeed, the Board did not even begin to hold a hearing until after the agreements had been in effect for two years.

The failure to hold a prior full hearing is particularly serious for three reasons. First, the need to limit capacity was one of the subjects often mentioned by major carriers during their frequent private conversations with Board members in 1969 and 1970. Such a background—even if the private meetings were conducted with great propriety—demands the fullest open hearings if public confidence in the agency is to be maintained.

Second, the agreements constituted a major departure from past Board policy. Past Board cases indicated that the Board would not approve agreements repugnant to basic antitrust policy without a clear showing that a serious transportation need or other public benefit required approval. These agreements had enormous practical impact; they were plainly repugnant to antitrust policy, and whether they could be shown to be necessary to secure an important public benefit was doubtful from the beginning.

Third, the Board exhibited confusion about how to apply antitrust standards in the airline industry. This underlined the need for a public explanation prior to approval of the agreements, of how they met the Board's standards or why those standards should be changed.

In the subcommittee's view, very low profits for one, two, or even three years do not create an emergency that warrants approval of seriously anticompetitive agreements without a Board hearing.

4. Conclusions.

a. The Subcommittee believes that capacity restricting agreements do not represent a practical solution to industry problems of overcapacity.

b. The Board's failure to hold a full hearing prior to allowing the agreements to take effect was unsound administrative practice, effectively foreclosing the opportunity of many of the agreements' opponents to argue their position.

c. Experience with capacity restricting agreements and with agreements setting minimum charter rates strongly suggests that the Board is insufficiently sensitive to antitrust policy and the need

to minimize departures from competitive standards. Contrary to its expressed policy it has, in practice, been willing to approve seriously anti-competitive agreements without insisting upon a showing that they are necessary to secure important transportation objectives.

D. ENFORCEMENT AND CONSUMER PROTECTION

The subcommittee has examined the way in which the Board exercises its powers to enforce its rules and to protect consumers. It concludes that the Board's first priority has been the protection and the development of regularly scheduled air service. Efforts to obtain lower fares or better service for consumers have played only a secondary role.

One measurement of enforcement priorities is an analysis of the Board's allocation of its field investigative time. Between January 1971 and October 1974 the Board spent about two-thirds of its filed investigative time trying to determine whether low-cost flights violated CAB regulations (restricting ticket discounting, unauthorized air transport, and charter flights). During that same period the Board spent only 3 percent of its field investigative time looking into consumer complaints (concerning, for example, overcharging, bumping, mishandled luggage). The CAB's Office of Consumer Advocate is also without adequate resources or authority to effectively perform its mission of protecting and advocating the interests of the consuming public.

Though the Board suggests more recently it has changed direction, the evidence concerning Board activity prior to 1975 confirms the impression made by the "field investigative time" statistics.

1. Enforcement that inhibits charter flights.—After hearing conflicting claims about whether the Board in its enforcement activities specifically discriminated against supplemental airlines—which provide charter service—the subcommittee has reached several conclusions:

First, the Board has misdirected its enforcement efforts. Far too many resources have been used in ways that inhibit low-cost travel in general and charter flights in particular. Far too few enforcement resources have been used to help the consumer.

Second, the Board's charter rules are unreasonably strict and

the procedures used to enforce them are unfair and absurd. More than 60 pages of documents must be filed with fees before each charter flight—and all must be refiled in the event of any minor change in plans. Up to the last minute the carrier may receive a Board telegram warning of a possible “unlawful” passenger on the flight as indeed there may be, since millions of travelers cannot understand why they should be forbidden to fly charter simply because they have not belonged to the fraternal group, club or ad hoc organization for six months prior to the flight. Thus, in the words of one witness, even “members of the clergy or congregations of churches” may sometimes falsely sign affidavits affirming six-month prior membership “without the slightest feeling of guilt.” Upon receipt of the telegram, the carrier may have to cancel the flight losing a great deal of money even if it does not know whether there are “unlawful” passengers in fact on board. The carrier may have to cancel the flight for it will fear that in a subsequent CAB penalty proceeding it will be shown that such a passenger existed.

Third, the Board allocates its enforcement resources primarily on the basis of complaints that it receives. Since competitors are far more likely to complain than travelers, this system automatically skews the system against the consumer.

2. *An example of the improper use of informal procedure to exclude a new competitor: The case of Air Europe.*—Air Europe obtained permission from Mexico and Luxembourg to fly between Tijuana and Luxembourg beginning Sept. 1, 1974, at a fare about half the regular Los Angeles-Europe rate. Air Europe believed that, since the flights took place outside the United States, no further CAB approval was necessary. The Board's staff, however, took a contrary position based upon the argument that the flights would constitute domestic travel (very questionable legal grounds) and that Mexico had forbidden Air Europe to market flights within Mexico (a blatantly incorrect factual assumption). The press then began to quote the Board or its staff as stating that Air Europe was “a cancer,” “a private operation,” that “we will stop them one way or another,” that the Government was considering “boarding a U.S. marshal on the flight in Tijuana and forcing the aircraft down in U.S. territory.” As a result of this publicity, travel agents

refused to handle Air Europe tickets and Air Europe was unable to begin service. It lost an investment of over \$400,000, and travelers lost low-fare service.

Had the CAB, before taking action, given Air Europe an opportunity to meet the claims against it, it would have argued that the important factual allegation was false and that the staff's legal case against it was invalid. Alternatively, if the Board's actions and allegations had not been discussed with the press, Air Europe might have remained in business until formal charges were brought and was given an opportunity to answer the charges against it. Instead, the public was deprived of low-fare air travel that might have been lawful through a combination of secret Board action and public press statements. At no point were the factual and legal merits explored in an adversary hearing.

In the subcommittee's view, the Board's method of proceeding was highly improper. And, its refusal to correct the damaging publicity for which it is responsible in part through having acted on false information is inexplicable.

Unfortunately, the Board's failings in this case are not uncommon. The subcommittee has found far too often—the case of minimum charter air fares, many route cases, basic route policy, and now Air Europe—that the Board either makes no effort to devise an appropriate adversary proceeding, or holds hearings only after a basic decision has been made. Moreover, this instance, together with the Board's treatment of Laker Airways' transatlantic application, the documented complaints of the supplemental airlines, and the Board's manpower-use statistics, suggests that the Board has concentrated its enforcement efforts upon stopping allegedly improper low-cost travel, persistently, and not always fairly.

3. *Failure to devote resources to consumer problems.*—In recent years the Board has spent about 3 percent of its field investigative resources on consumer problems, and it has devoted a fairly small proportion of its total resources to this area. Yet, such problems are serious.

Overcharging, for example, where travelers are sold more expensive tickets than they need to travel when and where they want is quite common. Consumer surveys indicate that a quarter or more

of tickets for connecting service are being sold at prices higher than the minimum lawful tariff. It has been suggested, in fact, that about half of all air travelers pay too much for their flights.

The main cause of overcharging is the complexity of tariffs, but the airlines themselves contribute by making little effort to see that customers are sold the lowest priced ticket for their needs. To the contrary, it found that American Airlines instructs its salesman that "American's basic sales policy is to sell the highest priced product that the consumer is willing to buy to obtain the service he prefers." And, TWA instructs its salesman to encourage an immediate sale by telling customers that planes are nearly full, when they are not. Given this sort of policy and the complexity of tariffs, it is not surprising that many travelers fly at higher fares than those to which they are entitled.

To the subcommittee's knowledge the Board has not treated overcharging as a major problem, it has not examined the airlines' sales techniques, it has not read through their sales manuals; nor has it instructed the airlines to try to find the lowest fare that suits a traveler's requirements. In fact, when new discount fares took effect in January 1975 the Board did not require that passengers already holding tickets be told of possible savings; though when fares increase, the Board does require passengers already holding tickets to pay the premium.

Bumping is also common. Consumer organizations testified that more than 100,000 passengers are turned out of their confirmed seats each year because the airlines have overbooked the flight. Although some overbooking is unavoidable, Eastern Airlines has shown that harm to passengers can be minimized by giving prospective travelers the choice of a lower fare service that carries with it the risk of being bumped (and receiving a free trip on the next available flight). Other airlines, with Board approval, bump passengers indiscriminately: they are required only to offer compensation (in an amount equal to the fare) to those delayed more than 2 hours domestically or 4 hours internationally.

Moreover, the Board's procedures for dealing with consumer problems work very slowly. A complaint against Allegheny for refusing to pay compensation to bumped passengers took the Board three years to process; it took 8 years for the Board to re-

solve complaints of unfairness in the operation of airlines' VIP lounges. Despite numerous complaints about airlines' rules that limit their liability for negligently lost luggage to \$500, it took the Board more than a year and a half to decide to grant the petition of a consumer group (the Aviation Consumer Action Project) to open a rulemaking proceeding about them. And, more than a year passed without the CAB's taking action on a Consumer's Union petition that the Board review airline rules on transport of dogs, cats and other pets—rules that the Consumers' Union claimed led to the death of many animals.

Of course, not all problems can be solved at once, but the delay in this area contrasts starkly with the efficient enforcement mechanism that fires off telegrams at the slightest suspicion that a passenger who has not belonged to a travel club for 6 months has managed to get aboard a charter flight.

4. *Failure to investigate fully the possible illegality of certain airlines' political campaign contributions.*—On March 21, 1975, the subcommittee held a special hearing to consider evidence that a Board investigation of unlawful airline political campaign contributions had been improperly limited and later halted. The investigations were begun in the summer of 1973 after American airlines revealed that it had given unlawful campaign contributions in the 1972 presidential campaign. The Board wished to ascertain whether airlines had violated its rules requiring the *reporting* of political contributions.

At the outset the Board's Bureau of Enforcement was instructed by the Chairman's office to limit strictly the questioning of airline officials. Suspicious answers to investigators' questions were not followed up.

In early November 1973 Acting Chairman O'Melia was head of the Bureau of Enforcement. He testified that at the end of the first week of November Mr. Heye, the then Chairman's administrative assistant brought him a note from Chairman Robert Timm, telling him to close the 34 investigations. Mr. O'Melia testified that he said he would not do so. Mr. Timm and Mr. Heye strongly denied, in their testimony, the existence of any such note or instruction.

On November 5, 1973, all 34 investigations were closed, the pa-

pers were collected, put into 34 files and locked in the Bureau's safe. They remained there until found and brought to the subcommittee in February 1975 by the then head of the Bureau of Enforcement. Examination of those files suggests that the investigations were seriously incomplete.

The subcommittee's March 21 hearing suggests the possibility of highly improper or unlawful behavior on the part of Board officials. In light of the possibility of perjury flowing from the directly conflicting statements by an Acting Chairman and a past Chairman of the Board, and the possibility of an unlawful obstruction of administrative proceedings, the subcommittee has referred the record of the hearing to the Department of Justice to see whether criminal prosecution is warranted.

CONCLUSIONS AND RECOMMENDATIONS

In summary form, the subcommittee has concluded the following:

1. Many of the Board's procedures fail to meet commonly accepted standards of fairness and openness. In some instances major policies have been determined without a prior opportunity for the public fully to present arguments and alternatives. In other instances, individuals have been hurt as a result of procedurally unsound Board action. This conclusion applies, in particular, to the Board's route award procedures, the route moratorium, the "motion for expedited hearing," intervention by the Chairman's office in route cases, the "minimum charter rate" experience, the capacity restricting agreements, charter rule enforcement, the Air Europe case, and the campaign contribution investigation.

2. Board regulation has not effectively brought about the low-fare service that is technically feasible and that consumers desire. Instead it has sought primarily to protect the regularly scheduled airline industry and to promote regularly scheduled air service.

3. Air service can be made available to the American public at significantly lower prices. Increased competition is likely to bring about the provision of such service. The major alternatives to increased reliance upon competition, namely, stricter ratemaking standards, discount fares, and capacity restricting agreements, are less likely to prove effective.

4. To some extent the Board's failings reflect the inherent diffi-

culty of applying classical rate and entry regulation to a competitive, economically volatile industry. Classical ratemaking sets fares that equal costs (including a reasonable profit). Yet the Board's experience suggests it is extremely difficult, if not impossible, to develop a cost-based ratemaking system that uses fair procedures and keeps fares in such an industry low.

Classical entry regulation substitutes for impersonal market forces, which tolerate bankruptcies and allow the efficient, aggressive, or superior firms to survive, personal quasijudicial decisions by regulators, who inevitably feel responsible for the "health" of the firms they regulate, who tend to see "fair" decisions as those that treat with rough equality the various industry claimants before them, and who thus seek industry stability and improved service. Given the difficulty of fashioning a set of consistent standards for awarding routes that will meet these objectives, that will conform to statutory requirements, and that will help to keep fares low, it is not surprising that the Board has tended to avoid hearings, to rely on informal negotiation, and, when denying route applications, to substitute for substantive criteria, procedural ones which are less open to outside criticism or review.

Finally, the classical regulatory response to defects in regulation is to create more regulation: The Board's response to the problem of excess capacity was to introduce capacity restricting agreements. Yet, to do so in this highly competitive, complex industry brought the consumer the worst of both worlds, high prices and poor service.

This is not to say that inherent defects are the only cause of the CAB's failings. These may, for example, also reflect the human tendency to listen more closely to representatives, such as those for the industry, who are powerful, well-informed, and can reward regulators with future jobs or contracts. Or they may reflect the variety of political forces that the regulators must often take into account. Nor is it to say that classical regulation is always undesirable. In the case of some industries, it may be necessary. Yet classical regulation is not an appropriate tool for dealing with the problems of the airline industry. Defects in airline regulation run so deep that major change is required. Rather, reliance upon strong safety regulation, the antitrust laws to prevent predatory be-

havior, and the competitive process is more appropriate. Thus, a program of gradual, measured change towards increased reliance upon competition is called for.

The subcommittee's recommendations are designed to move gradually towards a system that increasingly relies upon competition, rather than classical regulation, to bring about low fares. It includes the following:

In the area of route awards:

1. Major shifts in Board policy should take place only after adequate opportunity is given both to members of the industry and the general public to submit views and arguments.

2. A summary judgment procedure should be developed to replace the motion for expedited hearing.

3. Standards governing ex parte communications should be revised.

4. Strict time limits governing route cases should be developed and enforced.

5. The "route moratorium" should be officially terminated.

6. The program of gradually liberalizing entry requirements should be adopted. Such a program might 1) immediately allow the removal of route restrictions and begin to count an offer to lower fares as a factor in favor of granting a route; 2) immediately liberalize charter rules; 3) after an interim period allow any carrier to fly a route segment connecting with its present system on a showing that it is "fit, willing, and able" to do so; 4) allow supplemental carriers to do the same; and 5) eventually allow any firm wishing to supply air service on a route to do so on a showing that it is "fit, willing, and able."

In the area of rates:

1. Allow carriers flexibility to charge the prices they desire. The Board should retain a rate ceiling, but no floor, removing the ceiling only when entry rules become sufficiently liberal for the threat of new competition to hold prices down.

2. Liberalize restrictions on charter travel.

3. Allow the carriers wide latitude to introduce systems of price discount.

Antitrust immunity:

1. Adopt a standard that would prohibit any act that would violate the antitrust laws unless the anticompetitive effects are clearly out-weighed in the public interest by the need to secure a significant transportation objective.
2. Establish liaison with the Department of Justice and the Department of Transportation so as to make appropriate use of their expertise in resolving these questions.
3. Develop standards for determining when hearings shall be given before granting requests for antitrust immunity. The standards should provide for hearings in controversial cases.

Enforcement:

1. Develop a procedure for allocating enforcement resources that does not depend entirely upon responding to complaints.
 2. Assign a significant number of personnel the job of enforcing consumer oriented regulations.
 3. Increase the budget of the Office of Consumer Advocate and consider an expanded program of consumer protection including, possible strict liability rules governing lost or damaged luggage, voluntary bumping systems, requirements that passengers already holding tickets be told of possible savings through fare reductions, spot checks on fare quotations to help stop overcharging, the development of a method by which airline ticket salesmen can speedily inform callers of low cost promotional, or other low cost, fares.
- The subcommittee also recommends legislation designed to achieve these basic objectives.